EFFECTS OF ADJUSTMENTS IN STATED CAPITAL AND PAID-IN SURPLUS ON THE ECONOMIC POSITION OF CORPORATE STOCKHOLDERS AND CREDITORS

BY

WILLIAM JOSEPH SCHLATTER

A.B., University of Illinois, 1933
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AN ABSTRACT OF A THESIS

SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE DEGREE OF DOCTOR OF PHILOSOPHY IN
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EFFECTS OF ADJUSTMENTS IN STATED CAPITAL AND PAID-IN SURPLUS ON THE ECONOMIC POSITION OF CORPORATE STOCKHOLDERS AND CREDITORS

The primary purpose of this study, as indicated in the title, is to examine the effects of adjustments in stated (legal) capital and paid-in surplus on the economic position of those who have claims in the corporation. Stated capital and paid-in surplus are the two principal elements of originally contributed capital. Some of these effects on the economic position of the equity-holders have already been discussed by writers on corporate problems but the several adjustments have been treated as relatively unrelated. Further, there is no unanimity of opinion among these writers regarding these effects and their advisability and equitableness. Therefore, it has been thought worthwhile to organize into one study the related problems of adjustments of stated capital and paid-in surplus, and to examine the possible effects of these adjustments on the various parties possessing claims in the corporation. Adequate judgments concerning the fairness of such adjustments has to be preceded by the determination of their effects; this study is an attempt to determine these effects.

In approaching this study, the point of view of a board of directors that is interested in protecting and equitably balancing the rights of all equity-holders (including the creditors) has been kept in mind. An attempt has been made to discuss the effects that would interest them. This study is not descriptive of particular adjustments that have been made, but is an analysis of the effects that may be expected from such adjustments generally.

It has been deemed necessary to include within the scope of this work, an examination of the legal limits within which those who control the corporation are free to act in making these adjustments, and to discuss the importance of accurate reporting in establishing reasonable expectations for equity-holders.

Various types of changes are possible in the pattern of the equities in a corporation. The most drastic of the changes in this pattern, which is sometimes called the capital structure, take place in a complete reorganization of the corporation, in which the relations among the rights of the various equity-holders are substantially altered. An example of a slight change in the capital structure is the establishment of a surplus reserve. Most of these changes have some effect on the rights and expectations of the equity-holders. The laws require that some of these changes be made with the consent of the equity-holders; other changes can be made legally without their approval.

This study is concerned with a type of change in the capital structure which lies somewhere between the two extremes. It has to do with the effects of the types of equity adjustments brought about by the determination of and changes in the stated capital and paid-in surplus of the corporation on the economic position of the various equity-holders. The power to make decisions concerning some of these adjustments rests entirely with the board of directors; the power to make decisions concerning others of these adjustments rests with the board of directors and the stockholders jointly. For none of them, does the law require the consent of all the equity-holders.

At the present time, the limits set by the law on the determination of and changes in stated capital and paid-in surplus are wide. The considerable freedom exercised by boards of directors and stockholders in changing stated capital and paid-in surplus may substantially affect the interests of all equity-holders, including, of course, those who have no voice in the decisions. In the absence of complete legal controls to direct those in control of corporations, some guidance is offered by a developing consensus in the business world regarding financial processes and conditions. This consensus, which is sometimes referred to as financial policy, offers some guidance in adjustments of capital structure. The law is still undeveloped, in part because these policies have not been fully evolved. It is to be expected that the law will recognize and codify established rules governing business and financial relationships rather than define beforehand the relations which should exist between various parties. The latter would be to expect too much of lawmakers; if such a burden were put upon them, we could expect the enactment of a rigid and unsuitable set of laws. The financial policies now being evolved may help determine the future development of the law.

An examination of works on corporation finance will reveal that there are few policies having to do with stated capital and paid-in surplus that have yet received general acceptance. Further, some of the policies as stated by writers on corporation finance need further examination to determine whether or not they really serve the purposes that they are assumed to serve. The study of this subject, the effects of adjustments of stated capital and paid-in surplus on equity-holders, is desirable as a preliminary to the development of satisfactory policies. The statements of writers on corporation finance, law, and accounting have been examined to determine what current opinions are regarding these problems; some of these statements have been adopted, others rejected for purposes of this study.

It should be recognized that those empowered to adjust stated capital

and paid-in surplus, the directors, or the directors and stockholders, might be concerned selfishly with their own interests in the corporation. The other equity-holders of such corporations may eventually receive what protection financial policy can give and perhaps ultimately added protection by law. For equity-holders of corporations whose directors are concerned with maintaining the rights and satisfying the reasonable expectations of all equity-holders, such added protection is, of course, less needed.

The rights of the equity-holders are determined by the provisions of the statutes governing the corporation. The variations in the statutes make it difficult to state accurately the significance to the stockholders and creditors of stated capital and paid-in surplus. Usually, the limitations put on stated capital provide that it may not be reduced by dividend declarations nor by the purchase by the corporation of its own non-redeemable stock. There are exceptions to this generalization; some states permit the declaration of dividends out of current earnings when stated capital is impaired, thus effectively reducing stated capital by dividends; others permit stated capital to be reduced by the purchase by a corporation of its own stock. We may say that stated capital usually provides a limit below which the excess of the assets over the liabilities may not be reduced by dividends and purchase of the corporation's own stock, and thus serves as a buffer which helps protect the creditors and the preferred stockholders of the corporation.

Paid-in surplus may be reduced by dividends on preferred stock only, in some states, but in many others, it may be reduced by dividends on common stock as well. In the former group of states, paid-in surplus serves as an additional buffer of protection to the creditors and to the preferred stockholders.

The expectations, as well as the legal rights, of the equity-holders are affected by the determination of and changes in stated capital and paid-in surplus. The larger these two items of stock equity are, the greater is the probability that the assets will be sufficient to meet the claims of the creditors and preferred stockholders.

The original determination of the amounts of stated capital and paid-in surplus is not necessarily final. These amounts may be changed with consequent changes in the relative rights of the equity-holders. The reduction in stated capital may take place effectively in some states by dividends declared out of current earnings when stated capital is impaired; in some states it may take place by the purchase by a corporation of its own shares; in many states, stated capital may be reduced by the redemption of redeemable stock. Stated capital may be increased by

transfers from surplus, with or without a stock dividend. In many states, paid-in surplus may be reduced by dividends, by purchases by a corporation of its own stock, and by transfers to stated capital; it may be increased by transfers from stated capital.

The laws permitting these changes do not require the consent of the creditors for any of them. Except for the reduction of stated capital, for which the approval of the stockholders is usually required, the power to make these changes rests with the board of directors.

The conclusions of this study are drawn on the assumption that it is desirable for those in control to protect and to balance the interests of all equity-holders. One conclusion that appears to be justified is that, for each type of adjustment, there is no single answer that can be given which will satisfactorily fit all cases. One cannot say definitely, for example, that the stated capital of a corporation should always be determined to be equal to all (or any specified portion) of the consideration received for stock upon its issuance. Nor can one say that cash dividends should never be permitted to result in a reduction of paid-in surplus. There are occasions when the reduction in paid-in surplus by the purchase by a corporation of its own stock is reasonable; there are other occasions when it is not. It may sometimes be reasonable to reduce stated capital; at other times it may not be. Sometimes it is reasonable to increase stated capital; at other times it is unreasonable.

The differences in the answers called for in different cases, to the question of whether or not a particular adjustment of stated capital or paid-in surplus should be made, are the results of differences in the existing and prospective relations among the equity-holders. For example, the directors and stockholders of a corporation that has only one class of stock and a small amount of liabilities may reasonably take a point of view toward the reduction of stated capital entirely different from that which they could reasonably take if the corporation had outstanding preferred stock and bonds, or if they expected to issue them. Laws and contracts establish limits which partly govern these relations among the equity-holders, but usually these limits are broad enough to permit considerable freedom of action within them. The discretion of those in control of the corporation thus becomes important, and guides are needed to help them determine the equitableness of decisions affecting the creditors and stockholders.

Some guides which may be useful are the expectations of the several classes of equity-holders. The equity-holder's expectations concerning the future returns from his claim are important to him; these expectations are significant factors in his estimate of the value of his claim. It has

been assumed, for purposes of this study, that the satisfaction of the reasonable expectations of the equity-holders is important.

There are two difficulties involved in the use of equity-holders' expectations as guides in making adjustments of the capital structure. In the first place, there may be considerable difficulty in determining what these expectations are. In the second place, once determined, they may be found to conflict. For example, the stockholders may expect dividends that reduce paid-in surplus and, at the same time, the bondholders may expect the maintenance of paid-in surplus. (The expectations of equity-holders may also conflict with the expectations of other interested parties, e.g., the employees. The interests of employees, customers, and the public in the modern corporation are important, but fall outside the scope of this study.)

Accurate and careful reporting of the financial affairs of the corporation will help to reduce both difficulties. Such disclosure will serve the purpose of establishing definite and more easily determinable expectations on the parts of the equity-holders. Those in control of the corporation may then be able to judge what expectations the equity-holders might reasonably come to have on the basis of the law, the contracts, and the disclosure of financial information. These may not be the exact expectations of the equity-holders, but they should usually be fairly close to them. The exact expectations of each equity-holder would, of course, be nearly if not quite impossible to determine.

Accurate and careful reporting may serve to reduce the second difficulty, that of conflicting expectations, by preventing the development of such expectations. For example, the directors may intend to use paid-in surplus as a basis for dividend declarations. Disclosure of the legal possibility of such use may prevent a conflict of expectations between stockholders who expect dividends that reduce paid-in surplus and creditors who expect its maintenance.

It is not intended to suggest that expectations are the only and infallible guides to the determination of the equitableness of adjustments of stated capital and paid-in surplus. When a person becomes an equity-holder in a corporation, he does so because he judges that what he expects to get for becoming an equity-holder has a present value at least as great as the cost of the security to him. But at a later date, his expectations may be changed so that, if he could make his original investment decision over again, he would withhold his funds from the corporation. For example, bondholders may have advanced funds to the corporation with the expectation that stated capital would be maintained. Later, the corporate directors may announce that they intend to reduce the stated

capital and declare dividends out of the reduction surplus, and thus reduce the amount of the asset protection to the bondholders. This announcement will probably change the expectations of the bondholders, but this is not sufficient reason for the directors and stockholders to decide to reduce stated capital. The expectations that should be satisfied, if possible, are those which induced the equity-holders to invest their funds in the corporation.

By referring to the expectations that may reasonably be held by the equity-holders, certain general conclusions may be reached concerning some of the adjustments of stated capital and paid-in surplus. The stated value of par value shares ought ordinarily to be par; it would be reasonable to expect it to be par in view of the common law rule that the stated value of par value shares is par, by the same rule expressed in the statutes of many states, and by the custom of corporations. We may also reach the conclusion that dividends should normally not be paid when stated capital is impaired even in states that permit it, because the reasonable expectations raised by the legal requirement that dividends may not impair stated capital would appear to be that stated capital is to be maintained. The rules regarding the impairment of stated capital are ineffective unless they are interpreted as setting quantitative limits on the reduction by dividends of the stockholders' equity. If an impairment of stated capital is not made good before dividends are declared, the expectation of this minimum quantitative limit on the reduction in the stockholders' equity is not satisfied, with consequent possible injury to creditors. The conclusion may be reached that, with minor exceptions, it is probably better for a corporation to refrain from purchasing its own stock. The normal expectation of the security-holders would be that the funds that they have invested will be used for the conduct of the business of the corporation and not for the purchase of the corporation's own shares from part of the stockholders. The redemption of redeemable shares has much the same effect as the purchase of the corporation's own non-redeemable shares, but we may come to a different conclusion regarding its equitableness, since the expectations of the equity-holders reasonably would be that corporate funds might be used to redeem the stock. The conclusion may be reached that it is often safer to refrain from declaring stock dividends, because of the danger of their misinterpretation, and because most of their results can be attained by the use of less misleading methods.

However, expectations that are contrary to the usual ones may be established by reporting or otherwise. If they can be determined and are not conflicting, they should be satisfied if possible. Expectations

differing from the usual ones may make reasonable the determination of an amount other than par as stated value, the declaration of dividends when stated capital is impaired, the purchase of treasury stock, and the declaration of stock dividends. These adjustments may reasonably be made when non-conflicting expectations of equity-holders point to them. Ordinarily, however, the equity-holders' expectations point in other directions.

VITA

William Joseph Schlatter was born November 25, 1912, at Brookings, South Dakota. He attended grade schools at Brookings, South Dakota, Pulaski, Iowa, and Urbana, Illinois, and graduated from Urbana High School in 1929. He entered the University of Illinois in September of 1929 and received a Bachelor of Arts degree in Philosophy from the College of Liberal Arts and Sciences of that university in 1933. In 1934, he was granted a degree of Master of Arts in Economics by the University of Illinois. In 1935, he was granted a Bachelor of Science degree in Banking and Finance by the College of Commerce of the University of Illinois. He has studied economics as a graduate student at the University of Wisconsin (1934-35) and at the University of California (1937-38). He received a certificate as a Certified Public Accountant from the State of Illinois in 1946.

He held an instructorship in accounting, business law, and sociology at Geneva College from 1935 to 1937. He was a teaching assistant in the Department of Economics at the University of California during the year 1937-38. From 1938 to 1944, he held an instructorship in economics at Yale University. From 1944 to 1946, he was in the Accounting Division of the Office of Price Administration. From 1946 to date, he has been an assistant professor of accounting in the School of Business Administration at the University of Michigan.

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